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C O N F I D E N T I A L SECTION 01 OF 03 ANKARA 000464

SIPDIS

STATE FOR E, EUR/SE, AND EB/IFD
TREASURY FOR OASIA - LOEVINGER, MILLS AND LEICHTER
NSC FOR BRYZA AND MCKIBBEN

E.O. 12958: DECL: 01/22/2009
TAGS: EFIN ECON PGOV PREL TU
SUBJECT: IMF RESREP: TURKEY IS OFF TRACK

REF: A. ANKARA 379
¶B. ANKARA 259
¶C. ANKARA 136
¶D. ANKARA 128

Classified by Economic Counselor Scot Marciel for reasons 1.5 (b) and (d).

¶1. (C) Summary: Despite diplomatic public statements, the first stage of the IMF's Seventh Review Mission found Turkey to be seriously off-track, according to IMF Resrep Odd Per Brekk. The backsliding is notable with regard to two "pillars" of the program--fiscal discipline and banking sector reforms, though the IMF is not saying so publicly. Contrary to press reports, the IMF and the GOT are still far apart on fiscal measures needed to close the estimated 2 percent of GDP fiscal gap forecast for 2004, as a result of a combination of recent populist measures and a pre-existing gap in meeting 2003 fiscal targets. In Davos and Washington, IMF M.D. Kohler and Deputy M.D. Krueger will deliver strong warnings to senior GOT officials. Brekk and his deputy pointed out that a message of "stick to the economic reforms" is unlikely to be as effective as a message of "Turkey needs to get back on the reform track." End Summary.

Confusing Press Reports on the first stage of the Seventh Review Mission:

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¶2. (Sbu) As the IMF Seventh Review Mission left Turkey January 21, the Turkish Treasury issued a statement that the IMF had accepted the GOT's plan to cut discretionary spending ten percent to help offset the recent, budget-busting minimum wage and pension hikes. In earlier telephone conversations, and in a meeting January 23, IMF Resident Representative Odd Per Brekk and his deputy, Christoph Klingen, explained that the IMF had consented to the ten spending cut as a necessary--but in no way sufficient--compensatory measure needed to partially cover the expected fiscal gap. Brekk lamented that much of the local press and the finacial analyst community had interpreted the Treasury statement as implying the Fund and GOT had reached agreement on the necessary fiscal measures, when, in fact, they are far apart.

GOT-Fund differences on filling the Fiscal Gap:

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¶3. (C) On fiscal issues, the IMF sees a 2004 fiscal gap of about 2 percent of GDP, caused by a combination of the recent populist measures and the 2003 gap which is carrying over into 2004. Though final 2003 numbers are still not available, the IMF is fairly confident that the GOT missed the critical 6.5 percent primary surplus target for 2003 by about a half a percent of GNP, mostly due to revenue shortfalls. Brekk explained that the IMF staff proposed a list of possible compensatory measures to the GOT worth about four percent of GNP, i.e. a menu of possible cuts from which the GOT could choose. After meeting the Prime Minister, however, Babacan said that none of the Fund-proposed options were politically acceptable.

¶4. (C) Before the IMF mission, the GOT announced a ten percent across-the-board cut in discretionary spending. Brekk noted that the IMF staff have concerns about this approach, since it is a far from ideal way to deal with fiscal problems and the IMF does not want to leave Turkey with a "messed-up" fiscal structure. On the other hand, faced with no other options on which the two sides can agree yet, the IMF is going along with the across-the-board approach, which includes large cuts in the

already-beleaguered investment budget. Brekk said that the Fund may even conclude there needs to be a higher-than-ten per cent cut, but it may be too late since the GOT is already putting the legislation before parliament.

¶5. (C) To cover the rest of the gap (about one percent of GNP, per the Fund), the GOT is proposing other measures that are either not credible to Fund staff, or represent backsliding on the IFI goal of reducing bank intermediation costs. Among the latter were GOT proposals to increase the resource utilization tax and increasing the withholding tax on deposits. Brekk said these were unacceptable to the IMF. The GOT is also pushing for a reduction in the Value-Added Tax on textiles and pharmaceuticals. Though the pharmaceuticals VAT reduction will not help the fiscal situation and is motivated by social objectives, Klingen said it is not expected to result in a significant fiscal cost because it would reduce government health spending. On the other hand, Brekk and Klingen said the GOT is claiming that the textile VAT reduction will increase government revenue because it will result in a reduction in fraudulent refunds on exports. Brekk said this was not credible, and Klingen pointed out that it was odd that the textile industry would be so supportive of a measure that the GOT believes will increase tax reveneue from their sector.

¶6. (C) According to Brekk, Unakitan argues that the IMF should allow "a detour" from strict fiscal targets until the long-term benefits of the GOT's tax administration reforms improve revenue collection. Separately, Brekk told us that one of the few areas of agreement during the mission was on Tax Administration reforms. Klingen explained that Unakitan has agreed to make the General Directorate of Revenue (GDR) more autonomous, to create a large-taxpayer unit within the GDR, and to have tax collection less dependent on the "Deftedars" at the local level, basically local Ministry of Finance offices that are not fully controlled by the GDR.

Banking Sector back to "Square One":

¶7. (C) Aside from fiscal policy, the other "pillar" of the program on which Fund staff are feeling discouraged is the banking sector. In an earlier meeting with U.S. Treasury banking sector technical advisors, Klingen said IMF staff are not sure whether they are back to "square one" or "minus one." First, though the jury is still out on the new managements of the now separate bank supervisory agency (BRSA) and deposit guarantee fund (SDIF), the new managers do not appear to be as qualified as their predecessors and are replacing the entire second-tier of management, if not the levels below that. At SDIF, a tender of assets from intervened banks recently failed, when the outgoing SDIF board rejected all the bids as too low. Second, Brekk noted that the recent court decision--if not reversed on appeal--overturning the SDIF's takeover of Kent Bank and Demir Bank could badly undermine the bank regulators' ability to take action. Though GOT officials protest that both the judiciary and the regulators are independent, the effect of a court negation of the Demir Bank takeover would affect one of the few large foreign investments in Turkey recently, that of HSBC in buying Demir. Brekk also agreed with econoffs' worries about the stalled state bank privatizations, and the enlargement of state-owned Halk and Ziraat through the likely merger of Pamuk Bank into Halk and the transfer of the Imar Bank deposits to Ziraat.

Letting Failed Bank Owners Back into the Banking System:
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¶8. (C) If the Demir case is not reversed, the court ruling would allow the owners who allowed Demir Bank to fail to regain ownership of the bank. In another, higher-profile case, the IMF is concerned about the controversial Cukurova group's proposal to SDIF and BRSA to restructure its debts to SDIF and Yapi Kredi Bank, as well as to regain control of Yapi Kredi. Brekk and Klingen agreed that it should be a violation of the banking act for Cukurova to regain control of Yapi Kredi, but they have not ruled out that the GOT and BRSA might try to get around the "fit and proper" criteria in the act.

Central Bank Isolation:

¶9. (C) Brekk said there are no major issues on monetary policy. However, he noted that Central Bank Governor Serdengecti is feeling increasingly isolated even though

senior GOT leaders like Erdogan and Unakitan have learned the utility of verbally supporting Central Bank independence.

Post-program IMF role:

¶10. (C) With the end of the IMF's current Standby Arrangement coming to a close at the end of this year, GOT officials occasionally make public comments about life after the IMF. Brekk said they have warned GOT officials against these statements since they reduce the GOT's flexibility in case further IMF involvement is needed. Brekk said that, at a minimum, the IMF will have a post-program monitoring arrangement, as they have in Indonesia, or a Precautionary Stand-by.

Turkey needs to be told it is Off Track:

¶11. (C) Though some private analysts expect the GOT to take politically-difficult measures to get the program back on track after the March 28 municipal elections, Brekk pointed out that there is a new, opposite school of thought: that an emboldened Government will take a harder line with the IMF, and refuse to take the necessary measures. Brekk, seeming more pessimistic than he has since spring 2003, said that the economy remains very vulnerable, with huge debt payments into the foreseeable future(including a large redemption next week).

¶12. (C) Klingen made the point that when senior U.S. and IFI officials meet with Erdogan and Babacan at Davos and in Washington, a message of "stick to the reforms" risks being misinterpreted. Since Erdogan believes the GOT is on the reform track, this message will not be as effective as a warning that Turkey needs to get back on track. Klingen and Brekk said that Kohler and Krueger will be giving GOT leaders a strong warning to get back "on track."
EDELMAN